CES Attachment A

OVERVIEW COMMENTS OF THE COALITION OF ENERGY SUPPLIERS ON THE FIRST PHASE OF THE ILLINOIS COMMERCE COMMISSION'S RETAIL COMPETITION WORKSHOP INITIATIVE[1]

Introduction

Although Section 16-101A of the Illinois Public Utilities Act ("Illinois PUA") highlights many of the benefits of a competitive retail market — such as opportunities for lower costs and new products and services for consumers — it does not contain a working definition of retail electric competition.

A working definition of retail electric competition, approved by the Commission, could provide the Commission with a valuable tool for fostering retail electric competition. A working definition could serve to refine and focus the Commission's broad statutory mandate to promote retail electric competition by providing all interested parties with a common, clearer understanding of the competitive environment the Commission is aiming to achieve. A Commission-approved working definition of retail competition would also provide a benchmark of sorts, against which the Commission could measure the progress of its efforts to promote retail electric competition.

In arriving at a working definition of retail electric competition, we first briefly review the features of competitive markets and methods to define and identify competition, as well as the benefits of competition. Our comments also elaborate on the most important defining characteristics of competitive retail markets:

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[1] The positions set out herein and in Attachment A represent the positions of the Coalition as a group, but do not necessarily represent the positions of individual CES member companies.

- *Competition is a process.* Competitive markets are dynamic and provide opportunities for the transmission of price, cost, and consumer preference information.

- *Competition is characterized by rivalry between suppliers.* In competitive markets, suppliers engage customers and try to secure their business by offering lower prices, differentiated value-added services, and other features.

- *Potential competition is still competition.* Contestability, or potential competition, exists when potential rivals can threaten credibly to enter a market. This threat disciplines high prices and provides avenues for innovation to benefit consumers.

These defining characteristics hinge on low entry barriers and low transaction costs. Indeed, competitive retail markets cannot emerge or survive in an environment with legal entry barriers or with high transaction costs that make mutually-beneficial exchange between buyers and sellers difficult or impossible.

The Features of Competitive Markets: Defining and Identifying Competition

A workable definition of retail competition relies on identifying the features of competitive markets. Identifying when markets are "competitive" is often difficult. A competitive market generally leads to prices that equal average production costs in the long run, and the process by which that outcome is achieved is one of rivalry in the presence of low entry and exit costs. There are at least three (3) different ways to evaluate the degree of competitiveness in a market.

The **first** approach simply looks at the **number of firms** in a market. This view is based on the argument that a large number of firms indicates competition, while only one firm (a monopoly) indicates no competition. This simplistic approach has several problems, including the lack of a theoretical economic basis on which to determine how many firms a market needs to achieve a competitive outcome. In some markets, competitive outcomes occur with only two firms; other markets with two firms may result in collusion and monopoly-level prices.

Furthermore, the definition of the relevant market makes it even more difficult to determine how many competing firms there are in a given market. One reason why markets with two firms can yield competitive outcomes is that in such markets, those two firms have significant rivalry. Thus when looking at the number of competing firms in a market, the important factor to consider is not the number of competitors, but the degree to which they exhibit rivalry. One way to measure rivalry in a market is to consider changes in market share over time; another measure is new product offerings and service innovations.

A **second** approach relies on the direct measurement of the **difference between prices and average cost**. In competitive markets, prices should equal average costs over time, and firms competing in the market earn normal rates of return; in the absence of competition, prices exceed average costs and firms earn supranormal profits. There are serious problems with this approach. One problem is that the normal rate-of-return-result applies only in the "long run" and we simply do not know how long the economic concept of the "long run" is in terms of actual time. Short run profits do happen in competitive markets all the time (as do short run losses) and their existence at any point in time is absolutely no evidence of collusion or a lack of competition. A second problem is that calculating profit margins requires detailed knowledge of the costs (and risks) facing the firm that may be difficult to obtain.

A **third** approach is to **evaluate how open a market is to new competitors**. Do entry barriers prevent new firms from competing with the firms already in the market? If a market has only one firm, but faces potential competition from new entrants (i.e., it is "contestable"), the incumbent may still charge a competitive price to deter those entrants. Looking at the contestability of the market focuses on the kind of dynamic, rivalrous interactions that lead to

long-run competitive outcomes. If, for example, we had a contestable market in which only one firm or a small group of colluding firms were charging high monopoly-like prices, we would expect new entrants to come in and compete away the high prices. Thus the crucial evaluation to perform here to measure the competitiveness of a market is to estimate existing entry barriers; entry barriers are a prime indicator of whether a market is competitive (or contestable). This evaluation will provide information about the degree of competitiveness of a market that is superior to looking at the number of firms or the market shares, although those data will also be useful because they can indicate changes over time that are consistent with rivalry and contestability.

The Benefits of Competition

The Coalition proposes framing any definition of competition within the context of the benefits of competition. In many ways, the benefits of competition are easier to define and identify than competition itself, and those benefits illustrate insights that can sharpen the definition of competition.

Competition creates incentives for all market participants (consumers and producers) to allocate valuable resources efficiently in the short run, and to elicit the mix of products and services that best meet customer needs over time. Retail electricity competition empowers customers to make choices that fit their budgets, their lifestyles, and their ability/desire to bear price risk. This relationship can be expressed in both theoretical and practical terms.

Highlighting many of the benefits of a competitive retail electric market, the Illinois Public Utilities Act notes that an effectively competitive retail electric market:

- Operates efficiently. (16-101A(d).)
- Is equitable to all consumers (16-101A(d); provides opportunities for lower costs for users of electricity 16-101A(b); and provides opportunities for new product and services for customers. (16-101A(b).)
- Provides reliable, affordable, and environmentally safe electric service. (16- 101A(d).)
- Encourages the use of renewable resources and energy efficiency resources. (16-101A(e).)

Competitive markets create opportunities for customer choice, providing benefits to customers responding to market-based price signals. Competitive markets provide powerful incentives for all market participants to act in ways that benefit consumers. In the short-run, competitive markets reward suppliers for maximizing output using existing assets, while simultaneously deterring producers from operating uneconomic assets. These markets also provide consumers with accurate signals of the true costs of producing the goods and services they consider buying. These price signals permit consumers to take advantage of low cost goods and services and to protect themselves from excessive prices by switching to other substitutes when market conditions cause any particular good or service to become uneconomic. This process is known as "static" efficiency.

In the long-run, competitive markets provide even greater incentives for efficiency, while also providing consumers with further protections from excessive prices. Unlike regulated distribution utilities, competitive suppliers face the harsh reality that they will have to exit the industry unless they can provide their customers with goods and services at prices that are competitive with those offered by their rivals. Competition rewards businesses that excel at supplying customers with what they want at low cost, while punishing those that do not.

Retail competition is value-creating, producing new investment and innovation which yield new products and services.[2] As technology changes over time, retail competition is the mechanism for delivering product differentiation and cost reduction benefits to customers.[3] Moreover, while competitive markets reward successful competitors with higher profits, those higher profits also provide other businesses with powerful incentives to invest their capital to compete with those successful competitors. Over time, this new entry tends to reduce prices and, hence, profits to normal levels, to the benefit of consumers generally. This second type of efficiency is known as "dynamic" efficiency.

Traditional cost-based regulation cannot provide the incentives that bring about the benefits of competitive market processes. Economists and regulators have long understood that cost-based regulation is at most a second-best alternative to robust competition. On the one hand, retail competition allows market prices to provide valuable signals that enable producers and consumers to allocate resources. On the other hand, cost-of-service ratemaking regulation disconnects the prices individual customers pay from the marginal cost of providing them electricity service, resulting in inefficient energy consumption and production. In short, regulated rates do not satisfy either static efficiency conditions or dynamic efficiency conditions, and fail to induce optimal capital investment.

Moreover, cost-of-service ratemaking regulation requires the Commission to make inherently subjective decisions concerning capital asset decisions, cost allocation and cost

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[2] Telephone deregulation and innovation provides a concrete example of the benefits consumers have received as a result of a shift from regulation to competition. What telephone customer in 1970 (about the time of the beginning of restructuring in telephone competition) would have been able to articulate a preference for mobile cellular internet access? Competition provided the driving force that motivated entrepreneurs to make the investments required to create new value for customers in ways that consumers had never imagined.

[3] For an elaboration on this argument see Stephen C. Littlechild, *Competition in Retail Electricity Supply*, Cambridge University Department of Applied Economics Working Paper at 227 (2002).

functionalization that are unlikely to lead to economically efficient outcomes. Cost of service ratemaking regulation cannot possibly capture the rich and complex web of information required to move toward "efficient" pricing for electricity supply arrangements.

Additionally, the administrative process to implement cost-of-service ratemaking regulation imposes substantial cost on customers, the Commission, the utility and other market participants. Avoiding these types of costs in the future should be an important goal of the Commission. This point is particularly true in light of the previously noted fact that even when all of these costs are incurred, cost-of-service ratemaking regulation is inherently incapable of providing producers and consumers with the incentives required to achieve an efficient outcome in either the static or the dynamic sense.

Thinking about retail electricity competition as a process reinforces the point that competition and markets are not solely about lowest possible price, but are best thought about more broadly as a process for creating the greatest possible value for consumers.[4] The greatest benefits to consumers from competitive retail markets will come in ways that cannot be foreseen at this time (associated with innovation and new products). That said though, the foreseeable benefits of such competition are also substantial. In electric power, one of the most important dimensions upon which customers have different preferences that could be met by competitive retailers offering different products is price risk. Customers have varying degrees to which they are willing to bear price risk, depending on their income, the share of electricity cost in their budget, their facility with enabling technology, as well as other factors. Product differentiation

[4] Many telecommunications customers today pay higher bills than under regulation, but get much more for their money. Similarly, many people spend more per year on airline tickets than they did in the 1970s, but fly more and get more value from the service.

that enables customers to choose how much price risk to accept is a likely beneficial outcome of retail competition.

Choosing the level of price risk to accept is something customers must do daily in even the most basic economic decisions. Retail competition enhances the variety of alternatives open to customers. Multiple suppliers offering consumers multiple, competitive choices would make consumers better off by allowing them to choose the product that best fits their needs and by bolstering overall system reliability, as price would provide incentives to reduce demand and increase output in the right places and at the right time.

Successful retail providers will offer product attributes that consumers want to purchase and marketing and education materials that support those choices. For instance, if consumers are highly concerned about price volatility, they could choose fixed priced contracts that insure against price risk. If consumers are interested in green power, they could purchase renewable products. Consumers who may be interested in keeping their electricity bills equal over time could choose to pay their accounts through levelized billing. Some consumers may even choose to face variable prices, with higher prices during peak hours and the lowest possible price during off peak hours; this choice is likely to reduce consumption in those peak hours with higher prices. The effects of shifting demand away from peak would reduce their use in those hours, and the overall effect on prices in *all* hours could lead to lower electricity bills for all customers, including those who do not shift their usage.

Conclusion: The Commission Should Articulate A Competition Policy

Robust retail competition can only emerge in an environment with low transaction costs; specifically, with legal institutions that are clear and transparent. A clearly-stated competition

policy vision from the Commission would contribute to reducing the transaction costs associated with regulatory uncertainty, and would therefore promote mutually-beneficial exchange and consumer welfare.